OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: I.R.C. § 593 - Bad Debt Reserve Recapture

This Field Service Advice responds to your memorandum dated May 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Acquiring Parent =
Acquiring Subsidiary 1 =
Acquiring Subsidiary 2 =
Target Parent 1 =
Target Subsidiary 1 =
Target Parent 2 =
Target Subsidiary 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Year 1 = ____
u =
v =
w =
x =
y =

z =

ISSUES:

1. Whether the I.R.C. § 481(a) adjustment necessitated by a change in accounting method required as a result of a transaction described in section 381(a)(2) is to be taken into account directly by Acquiring Subsidiaries 1 and 2, or whether the adjustment is properly reflected on the final returns of Target Parents 1 and 2.

2. In what tax year or years is the section 481(a) adjustment described above to be taken into account?

CONCLUSION:

1. The amount of the tax increase attributable to the change in accounting method and to the section 481(a) adjustment is computed as if Target Subsidiaries 1 and 2 each had changed its method of accounting for its final taxable year immediately preceding the acquisition. However, Acquiring Parent is liable for the tax attributable to the method change and the section 481(a) adjustment.

2. Prop. Treas. Reg. § 1.593-13 has not been finalized. Accordingly, Acquiring Parent's reliance on the automatic change in method of accounting procedures described in Prop. Reg. § 1.593-13 is misplaced. Moreover, Acquiring Parent did not obtain permission from the Commissioner to change its method of accounting and spread the resulting section 481(a) adjustment over six years. Thus, Acquiring Parent must take into account the entire increase in tax attributable to the method change and to the section 481(a) adjustment in the year in which the acquisitions occurred, which is Year 1.

FACTS:

A. Acquiring Parent's Acquisition of Target Parent 1

On Date 3, Acquiring Parent acquired Target Parent 1 and its wholly-owned subsidiary, Target Subsidiary 1, a mutual savings bank. After the acquisition, Target Subsidiary 1 was merged into Acquiring Subsidiary 1, a large commercial banking subsidiary of Acquiring Parent. Thereafter, Target Parent 1 and its subsidiary ceased to exist as a separate legal entity. The merger constituted a reorganization described in section 368(a)(1). Prior to the merger of Target Subsidiary 1 into Acquiring Subsidiary 1, Target Subsidiary 1 maintained a reserve for bad debts in accordance with section 593. Acquiring Subsidiary 1 used the specific charge-off method of accounting for bad debts pursuant to section 166(a).

Target Parent 1 filed a final consolidated return for the taxable year Date 2 through Date 3. Included with this return was a copy of a Form 3115 (Application for Change in Accounting Method) filed by Target Subsidiary 1 in Date 1, for its Year 1 taxable year. Target Subsidiary 1 filed the Form 3115 requesting permission to change its method of accounting for bad debts from the reserve method under section 593 to the specific charge-off method under section 166. In a statement attached to the Form 3115, Target Subsidiary 1 proposed to take the net section 481(a) adjustment into account over six years pursuant to Rev. Proc. 92-20, 1992-1 C.B. 685. On the Form 3115, Target Subsidiary 1 indicated that for the year of change, Target Subsidiary 1 had either entered into or contemplated entering into a transaction to which section 381(c)(4) applied. Form 3115, Line 3h. The National Office denied Target Subsidiary 1's requested method change.

On its final consolidated return for the taxable year ending Date 3, Target Parent 1 reported a net operating loss of $u. In a statement attached to the return, Target Parent 1 stated that Target Subsidiary 1 included in income a section 481(a) adjustment of $v, which represented an amount equal to one-sixth of Target Subsidiary 1's reserve balance.

Acquiring Subsidiary 1 filed a Form 3115 with Acquiring Parent's Year 1 consolidated return, relating to Target Subsidiary 1's bad debt reserves. Acquiring Subsidiary 1 requested an "automatic change" of Target Subsidiary 1's method of accounting from the reserve method to the specific charge-off method pursuant to Prop. Treas. Reg. § 1.593-13 for the taxable year Date 2 to Date 6.

In computing Target Parent 1's operating loss deduction for Year 1, Acquiring Subsidiary 1 reversed out Target Subsidiary 1's section 481(a) bad debt recapture of $v included in Target Parent 1's final return. This resulted in an adjusted net operating loss deduction attributable to Target Parent 1 of $w, rather than $u reflected on Target Parent 1's final return. Acquiring Subsidiary 1 made this adjustment in response to the Service's denial of the Form 3115 filed Date 1. As a result of Acquiring Subsidiary 1's request for the automatic change from the section 593 reserve method to the specific charge-off method, Acquiring Subsidiary 1 included in income a section 481(a) adjustment of $v, which represented one-sixth of Target Subsidiary 1's bad debt reserve.

Examination contends that pursuant to section 381, the entire section 481(a) adjustment of $x should be included in Target Subsidiary 1's taxable income for purposes of computing the "hypothetical tax" under Reg. § 1.381(c)(4)-1(c). Examination further contends that the resulting tax increase should be taken into account by Acquiring Parent in its Year 1 consolidated return.

B. Acquiring Parent's Acquisition of Target 2

On Date 4, Target Parent 2 merged with and into Acquiring Parent. The merger constituted a reorganization described in section 368(a)(1). Thereafter, Target Subsidiary 2, a wholly-owned subsidiary of Target Parent 2, was merged into Acquiring Subsidiary 2, a large commercial banking subsidiary of Acquiring Parent. For all years prior to the merger, Target Subsidiary 2 computed its bad debt deductions pursuant to the section 593 bad debt reserve method. Acquiring Subsidiary 2 computed its bad debt deductions using the specific charge-off method in section 166.

Acquiring Subsidiary 2 filed a Form 3115 with Parent's consolidated return for the year ended Date 6, relating to Target Subsidiary 2's bad debt reserves. Acquiring Subsidiary 2 requested an "automatic change" of Target Subsidiary 2's method of accounting from the reserve method to the specific charge-off method pursuant to Prop. Treas. Reg. § 1.593-13. As a result of Acquiring Subsidiary 2's request for the automatic change from the section 593 reserve method to the specific charge-off method, Acquiring Subsidiary 2 included in income a section 481(a) adjustment of $y, which represented one-sixth of the entire section 481 adjustment of $z.

Examination contends that pursuant to section 381, the entire section 481(a) adjustment of $z should be included in Target Subsidiary 2's taxable income for purposes of computing the "hypothetical tax" under Reg. § 1.381(c)(4)-1(c). Examination further contends that the resulting tax increase should be taken into account by Acquiring Parent in its Year 1 consolidated return.

LAW AND ANALYSIS:

The reserve method of accounting set forth in section 593 is available only to thrift institutions described in section 593(a). Thus, to be eligible to use the section 593 reserve method of accounting, a taxpayer must be a domestic building and loan association, a mutual savings bank, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit. The taxpayer also must meet the total asset requirements of section 7701(a)(19)(C). Pursuant to section 585(c), large banks, as defined in section 585(c)(2), must use the specific charge-off method of accounting for bad debts.

Section 381(c)(4) provides that the acquiring corporation in a reorganization to which section 368(a)(1) applies shall use the method of accounting used by the transferor corporation unless the acquiring corporation and the transferor used different methods. In that instance, the acquiring corporation shall use the method prescribed by regulations.

Reg. § 1.381(c)(4)-1(a)(1)(ii) provides that the acquiring corporation shall take into account the dollar balances of those accounts of the transferor corporation which represent reserves in respect of which the transferor has taken a deduction for taxable years ending on or before the date of transfer. The amount of the adjustment necessary to reflect a method change, the manner in which the reserves are to be taken into account, and the tax attributable to such reserves shall be determined and computed under section 481, subject to the rules provided in Reg. § 1.381(c)(4)-1(c) and (d). See also, Rev. Rul. 85-171, 1985-2 C.B. 148.

Reg. § 1.381(c)(4)-1(c)(2)(iii) sets forth rules for determining the principal method of accounting for bad debts when the transferor and the acquiring corporation used different methods. Reg. § 1.381(c)(4)-1(c)(1) provides that when an acquiring corporation must use a different method of accounting for an acquired business than its transferor did, the adjustments necessary to reflect such change and any resulting increase or decrease in tax are determined as if the transferor had initiated a change in method of accounting on the date of transfer. The increase or decrease in tax shall be taken into account by the acquiring corporation. Id. In other words, a transferor should file its final return using its old method of accounting. The transferor would then compute a hypothetical tax based on the assumption that it had changed its accounting method for its final year. The acquiring corporation would then take into account directly the increase or decrease in tax which would be imposed on (a) the income that would have been reported by the transferor under the new method, plus (b) the section 481(a) adjustment that would have resulted had the change actually been made by the transferor. See, GCM 39,436, I-279-84 (Nov. 1, 1985).

In this case, prior to the reorganizations, Target Subsidiaries 1 and 2 maintained bad debt reserves in accordance with section 593. Acquiring Subsidiaries 1 and 2 are large commercial banks that are required to use the section 166 specific charge-off method of accounting for bad debts. The merger of Target Subsidiaries 1 and 2 into Acquiring Subsidiaries 1 and 2, respectively, are reorganizations described in section 368(a)(1) and subject to section 381(c)(4). Because Acquiring Subsidiaries 1 and 2 are not permitted to use the section 593 bad debt reserve method, a change in method of accounting is required pursuant to Reg. § 1.381(c)(4)-1(c). Target Subsidiaries 1 and 2 are required to recapture an amount equal to their bad debt reserve balances and compute their 481(a) adjustment subject to the rules provided in Reg. § 1.381(c)(4)-1(c). Thereafter, the resulting tax increase is taken into account by Acquiring Parent on its Year 1 consolidated return. Reg. § 1.381(c)(4)-1(c)(1).

Section 381(a) provides that the acquiring corporation shall take into account the items described in section 381(c) as of the close of the day of the transfer. Accordingly, the entire section 481(a) adjustment should have been taken into account by Acquiring Parent on its Year 1 consolidated return.

In Date 1, Target Subsidiary 1 filed a Form 3115 requesting permission to change its method of accounting and proposing to take the section 481(a) adjustment into account over six years. The National Office rejected this request. Target Subsidiary 2 did not file a Form 3115 prior to its merger into Acquiring Subsidiary 2. In short, the Commissioner did not grant permission to either Target Subsidiary 1 or Target Subsidiary 2 to change its method of accounting and to spread the resulting section 481(a) adjustment over six years. Furthermore, we are unaware of any authority for extending the "spread" provisions of Rev. Proc. 92-20, 1992-1 C.B. 685, to a change without consent. Accordingly, we conclude that Acquiring Parent must take the entire section 481(a) adjustments into account on its Year 1 consolidated return.

Acquiring Subsidiaries 1 and 2 filed Forms 3115 with Acquiring Parent's Year 1 consolidated return relying on Prop. Reg. § 1.593-13 for an automatic change in its method of accounting and a six year spread of the section 481(a) adjustment. See, Prop. Reg. § 1.593-13(c)(2)(iii). In 1992, the Service issued proposed regulations under section 593 to provide guidance for thrift institutions that become ineligible to use the section 593 reserve method of accounting for bad debts. See, Prop. Reg. §§ 1.593-12, 1.593-13, and 1.593-14. The proposed regulations provide rules for changing from the section 593 reserve method of accounting. However, the proposed regulations were never finalized, and thus, have never been in effect. Prop. Reg. § 1.593-12(c) provides:

> Effective date – (1) In general. This section and §§ 1.593-13 and 1.593-14 are effective for taxable years ending after [Insert date that is 30 days after this document is published as a final regulation in the Federal Register].

Prop. Reg. § 1.593-13 sets forth rules that, if effective, would provide for an automatic accounting method change procedure. The automatic method change procedure, however, does not apply to retroactive method changes. Prop. Reg. § 1.593-13(a)(1). A retroactive method change would be a request to change a method of accounting for years prior to the effective date of final regulations under section 593. To request a retroactive method change, a taxpayer must obtain the express consent of the Commissioner. Prop. Reg. § 1.593-12(c)(2)(i). Specifically, a taxpayer must file a Form 3115 pursuant to the applicable administrative procedures under Reg. § 1.446-1(e)(3)(i) stating that the institution is requesting retroactive application of §§ 1.593-12, 1.593-13 and 1.593-14 under § 1.593-12(c)(2). Prop. Reg. § 1. 593-12(c)(2)(ii).

Parent's reliance on Prop. Reg. § 593 is misplaced for two reasons. First, Parent improperly relied on a proposed regulation that has not been finalized. The Tax Court has held: "Proposed regulations are only preliminary proposals; they are not binding on [the service] or on the Court." Estate of Leavitt v. Commissioner, 90

T.C. 206, 218 (1988). See, Garvey, Inc. v. United States, 1 Cl. Ct. 108, 118 (1983), aff'd, 726 F.2d 1569 (Fed. Cir. 1984), cert denied, 469 U.S. 823 (1984). The Tax Court has made clear: "While proposed regulations do constitute 'a body of informed judgment . . .which courts may draw on for guidance, . . . we accord them no more weight than a litigation position.'" KTA-Tator, Inc. v. Commissioner, 108 T.C. 100, 102-103 (1997) (quoting, Frazee v. Commissioner, 98 T.C. 554, 582 (1992)(quoting Bolton v. Commissioner, 694 F.2d 556, 560 n.10 (9th Cir. 1982), aff'g 77 T.C. 104 (1981)). Similarly, in Miller v. Commissioner, 70 T.C. 448 (1978), the court rejected petitioner's and respondent's reliance on proposed regulations, stating: "[W]e do not rely on [Prop. Reg. § 1.51-2(b)(2)(i)] as authority since regulations which have not yet been formally adopted 'carry no more weight than a position advanced on brief by the respondent.'" Miller, at 460 (quoting, F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233, 1265-1266 (1970).

Second, even if the proposed section 593 regulations were finalized and made effective at some future date, Acquiring Parent misconstrues the potential application of the proposed regulations in this case. That is, if the regulations were effective at some future date, the application of the automatic change procedures in Prop. Reg. § 1.593-13 to the year in issue would be a retroactive application of the automatic method change procedures, a result prohibited by Prop. Reg. § 1.593-13(a)(1). Prop. Reg. §§ 1.593-13(a)(1) and 1.593-12(c)(2) make clear that an institution must obtain the express consent of the Commissioner to effectuate a retroactive change in method of accounting. Specifically, Prop. Reg. § 1.593-13(a)(1) provides: "Except in the case of a request for retroactive application under § 1.593-12(c)(2), if a former thrift institution complies with this section in changing from the reserve method of section 593, the change will be treated as made with the consent of the Commissioner." Thus, even assuming for purposes of discussion that the proposed regulations are finalized, the procedures that Acquiring Parent should have followed for purposes of changing its method of accounting for the year in issue are set forth in Prop. Reg. § 1.593-12, not § 1.593-13. See, KTA-Tator, Inc. and Mason v. Commissioner, T.C. Memo. 1997-352 (court concluded that notwithstanding that proposed regulations represent only the Service's litigation position, the taxpayer misconstrued the proposed regulations under section 7872).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If this case proceeds to litigation, you may wish to seek further Field Service assistance.

Please call if you have any further questions.

By: ______________________________

CAROL P. NACHMAN
Special Counsel
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cc: